

Message Text

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SUBJECT: TREASURY MINISTER COLOMBO REPORTS TO PARLIAMENT ON
LIRA CRISIS

PASS TREASURY AND FRB

/SUMMARY./ IN REPORT TO BUDGET COMMITTEE OF SENATE ON JANUARY
28, TREASURY MINISTER COLOMBO: (1) DESCRIBED THE BACKGROUND BEHIND
ITALY'S BALANCE OF PAYMENTS PROBLEM FROM 1972 TO DATE; (2)
REPLIED TO CRITICISM THAT PARLIAMENT AND PUBLIC SHOULD HAVE HAD
WARNING OF IMPENDING LIRA CRISIS; (3) CITED IMMEDIATE CAUSES OF LIRA
CRISIS AND JUSTIFICATION FOR WITHDRAWAL FROM MARKET BY BANK OF
ITALY; (4) EXPLAINED STATUS OF FOREIGN BORROWING NEGOTIATIONS AND
STRESSED IMPORTANCE OF FOREIGN DEBT BURDEN AS PART OF BALANCE OF
PAYMENTS CONSTRAINT ON GROWTH; (5) MENTIONED PRE-CONDITIONS
FOR BANK OF ITALY RE-ENTRY INTO EXCHANGE MARKET; (6) DEFENDED
MONETARY POLICIES WHICH LED TO INCREASE IN LIQUIDITY THAT
FACILITATED CAPITAL OUTFLOW AND STRESSED EFFECT OF CASH BUDGET
DEFICIT ON CREDIT DEMAND, AND (7) BRIEFLY TOUCHED ON MAIN ECONOMIC
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POLICIES NEEDED TO FACE CURRENT CRISIS, I.E., ONLY LIMITED USE

OF MONETARY POLICY, REDUCTION IN BUDGET DEFICIT AND REDUCTION
IN RATE OF INCREASE OF LABOR COSTS.

/END SUMMARY/.

1. /BALANCE OF PAYMENTS BACKGROUND./ TREASURY MINISTER GAVE
LONG EXPOSE OF CUMULATIVE BALANCE OF PAYMENTS PROBLEMS WHICH
BEGAN IN 1973 WITH WORSENING IN ITALY'S TERMS OF TRADE FROM
COMMODITY BOOM AND SUBSEQUENTLY FROM OIL PRICE INCREASE. HE
CITED CONSIDERABLE IMPROVEMENT IN BALANCE OF PAYMENTS
IN 1975 BUT ATTRIBUTED THIS IN LARGE PART TO EFFECTS
OF RECESSION ON IMPORTS.

2. /WARNING OF CRISIS./ COLOMBO REPLIED TO CRITICS OF GOI
AND BOI WHO THOUGHT PUBLIC AND PARLIAMENT SHOULD
HAVE BEEN FOREWARNED OF UPCOMING LIRA CRISIS. HE CITED
BELIEF THAT LARGE NOVEMBER DEFICIT WAS PARTLY REVERSAL OF SMALL
SURPLUS IN OCTOBER AND PARTLY REFLECTED BEGINNING OF DESIRABLE
INVENTORY BUILD-UP. IN DECEMBER THERE HAD BEEN DROP IN FOWARD
DISCOUNT ON LIRA AND IN SPREAD BETWEEN BLACK MARKET AND OFFICIAL
EXCHANGE RATES. IN FIRST HALF OF MONTH DEFICIT HAD BEEN VERY
SMALL; EC HAD AGREED WITH GOI ESTIMATE OF MODEST \$1.5
BILLION CURRENT ACCOUNT DEFICIT IN 1976, AGAINST WHICH OFFICIAL
RESERVE POSITION APPEARED ADEQUATE. FERTILE GROUND FOR EXCHANGE
RATE SPECULATION DEVELOPED IN JANUARY AS A RESULT OF GOVERNMENT
CRISIS, PRESS REPORTS OF LARGE DROP IN OFFICIAL ASSETS DURING 1975,
AND PRESS LEAKS OF COMPTROLLER OF THE CURRENCY EFFORTS TO BRING
U.S. BANKS WITHIN INDIVIDUAL BORROWER LIMITS. RESULT OF SPECULATION
WAS LOSS OF \$528 MILLION IN OFFICIAL RESERVES FROM INTERVENTION
IN FIRST TWENTY DAYS OF MONTH. ONLY ALTERNATIVE WAS WITHDRAWAL
OF BOI FROM MARKET, SINCE OTHER OPTIONS WOULD EVENTUALLY HAVE
RISKED EXHAUSTION OF RESERVES NEEDED TO FINANCE IMPORTS IN 1976 FOR
ECONOMIC RECOVERY.

3. /IMMEDIATE CAUSES OF CRISIS./ COLOMBO REPLIED TO CRITICS
OF RECENT MINOR LIBERALIZATION IN PAYMENT TERMS FOR EXPORTS
AND IMPORTS (BEING REPORTED SEPARATELY BY AIRGRAM) AS HAVING
HAD LITTLE EFFECT ON SPECULATION AND AS BEING JUSTIFIED BY NEED
TO HELP EXPORTS AND PERMIT RECOVERY OF IMPORTS. EXCHANGE
LOSSES REFLECTED BOTH LEADS AND LAGS AND SOME OVER-INVOICING OF
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IMPORTS AND UNDER-INVOICING OF EXPORTS. MINISTER CONCLUDED
THAT CRISIS WAS DUE BOTH TO STRUCTURAL PROBLEMS AND TO SHORT-
TERM FACTORS AND HE STRESSED SERIOUSNESS OF BALANCE OF PAYMENTS
CONSTRAINT ON ECONOMIC RECOVERY.

4. /STATUS OF FOREIGN BORROWING./ COLOMBO NOTED THAT, UNLIKE
PREVIOUS BALANCE OF PAYMENTS CRISIS, THIS TIME ITALY WAS IN POOR
POSITION TO RESORT TO INTERNATIONAL CAPITAL MARKETS FOR CREDIT.

GOI HAD IMMEDIATELY BEGUN TO EXPLORE NEW IMF DRAWING OF \$530 MILLION FOLLOWING JANAICA AGREEMENT, AND IT WAS HOPEFUL THAT AGREEMENT COULD BE CONCLUDED BEFORE END-FEBRUARY. EC JOINT BORROWING WAS STILL A POSSIBILITY BUT AMOUNTS AVAILABLE AND CONDITIONS ATTACHED TO LOAN WERE NOT YET CLEAR. NEW YORK FED HAD ALREADY MADE AVAILABLE \$250 MILLION UNDER SWAP LINE AND BUNDESBANK HAD INDICATED POSSIBILITY FOR RE-BORROWING \$500 MILLION UNDER GOLD LOAN ARRANGEMENTS. NONETHELESS, INCREASING INTEREST COSTS FROM CUMULATION OF FOREIGN DEBT HAVE ADDED FURTHER BURDEN TO FUTURE BALANCE OF PAYMENTS.

5. /RE-ENTRY OF BOI INTO EXCHANGE MARKET./ MINISTER SAID THAT RE-ENTRY OF BOI INTO MAKET DEPENDED NOT JUST ON RESOLUTION OF POLITICAL CRISIS BUT ALSO ON ADOPTION OF CLEARLY-DEFINED ECONOMIC PROGRAM WHICH WILL OFFER CLEAR PROSPECTIVES FOR BUSINESS. WHEN BOI DOES RE-ENTER MARKET, IT WILL DO SO TO ASSURE ORDERLY MARKETS, ELIMINATE ERRATIC FLUCATUATIONS AND ALLOW LIRA RATE TO REFLECT MEDIUM-TERM BALANCE OF PAYMENTS DEVELOPMENTS.

6. /MONETARY POLICY./ MINISTER DISCUSSED INCREASED DEMANDS FOR CREDIT TO FINANCE TREASURY CASH BUDGET DEFICIT, NOTING THAT DEFICIT IN 1972 REPRESENTED 8.2 PERCENT OF GNP BUT 14.4 PERCENT OF GNP IN 1975. HE POINTED OUT THAT DEFICIT REPRESENTED ULTIMATE EFFECT OF SERIES OF CHOICES MADE BY GOVERNMENTS AND PARLIAMENT AND THAT CURRENT ADVERSE EFFECTS OF DEFICIT SHOULD BE WARNING RE FUTURE CONDUCT, ESPECIALLY NOW THAT ITALY HAS REDUCED POSSIBILITY OF RESORT TO FOREIGN CREDIT. MONETARY AUTHORITIES HAD MADE EVERY EFFORT TO KEEP LIQUIDITY UNDER CONTROL AND HAD DEVELOPED NEW POLICIES AND MONETARY INSTRUMENTS FOR THIS PURPOSE, E.G., STERILIZATION OF LIRA COUNTERPART OF EUROMARKET LOANS, PRIOR IMPORT DEPOSITS, NEW TYPE OF SHORT-TERM EXPORT CREDIT REFINANCING, DIRECT BANK CREDIT CONTROLS, FORCES BANK INVESTMENTS IN SECURITIES, AND REFORMS OF TREASURY BILL

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AUCTION SYSTEM AND OF BANK RESERVE REQUIREMENTS. ONE EFFECT OF GROWING CASH BUDGET DEFICIT ON CREDIT AVAILABILITY HAS BEEN TO CROWD OUT BUSINESS, ESPECIALLY PRIVATE BUSINESS.

7. /ECONOMIC POLICIES TO BE FOLLOWED./ MINISTER COLOMBO EMPHASIZED THE NEED TO PROMOTE INVESTMENT, GIVING PRIORITY TO INDUSTRIAL RESTRUCTURING. ECONOMIC POLICIES SHOULD AIM AT THREE COMPLEMENTARY OBJECTIVES; LIMITATION ON PUBLIC SECTOR DEFICITS, REDUCTION IN IMPACT OF COST OF LABOR ON UNIT COSTS, AND CONTROL OVER LIQUIDITY AND DOMESTIC INTEREST RATES, WITH LATTER TO BE KEPT HIGHER THAN FOREIGN RATES. AS TO POLICY INSTRUMENTS TO BE USED, COLOMBO REPEATED THAT GOI HAD NO INTENTION OF RESO-RTNG TO TRADE OR EXCHANGE CONTROLS BECAUSE THIS WOULD BE INCOSISTENT WITH MEMBERSHIP IN INTERNATIONAL ORGANIZATIONS AND WITH POSSIBILITIES FOR OBTAINING FOREIGN FINANCING. GOI

DID NOT CONTEMPLATE PREMINENT ROLE FOR MONETARY AND CREDIT CONTROLS. SHORTTERM BALANCE OF PAYMENTS PROBLEM WOULD BE TREATED THROUGH USE OF FREE FLOATING EXCHANGE RATE. ON OTHER HAND, THERE SHOULD BE RIGID CONTROL ON BUDGETARY CURRENT EXPENDITURES AND MEASURES SHOULD BE TAKEN TO INCREASE REVENUES. FINALLY, RIGOROUS AND RESPONSIBLE POLICY SHOULD BE ADOPTED REGARDING LABOR DEMANDS, WITH MEASURES TAKEN TO IMPROVE LABOR PRODUCTIVITY. IN MEDIUM-TERM THERE WAS NEED FOR MORE EFFECTIVE UTILIZATION OF FUNDS SPENT FOR SOCIAL BENEFITS.

8. /COMMENT/. COLOMBO'S TESTIMONY WAS RESULT OF PROMISE TO PARLIAMENT AT TIME OF WITHDRAWAL OF BOI FROM EXCHANGE MARKET TO EXPLAIN REASON FOR GOI ACTION. STATEMENT WAS RATHER LONG ON FACTS AND DEFENSE OF GOI POLICY AND SHORT ON OUTLINE OF SPECIFIC POLICIES TO BE FOLLOWED TO DEAL WITH BOTH SHORT-TERM AND LONGER-TERM ECONOMIC PROBLEMS. THIS POSITION IS NOT SURPRISING, GIVEN FACT THAT FUTURE ECONOMIC POLICIES ARE STILL POINT OF CONTENTION AMONG POLITICAL PARTIES DURING STILL-UNRESOLVED GOVERNMENT CRISIS. COLOMBO HAS POINTED OUT CLEARLY THAT STRONG POSITION TAKEN IN CERTAIN POLITICAL AND LABOR CIRCLES AGAINST CREDIT SQUEEZE, WHILE UNDERSTANDABLE IN VIEW OF DESIRE TO AVOID NIPPING RECOVERY IN THE BUD, MEANS THAT OTHER POLICY INSTRUMENTS MUST BE USED, INCLUDING MEASURES TO DEAL WITH CONTINUOUSLY GROWING CASH BUDGET DEFICIT AND HIGH RATES OF INCREASE IN LABOR COSTS, BOTH OF WHICH INVOLVE HIGHLY SENSITIVE POLITICAL ISSUES. VOLPE

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